



AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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The Changing Pattern of
Credit Flows in the 1980s:
A Review Article

Highlights

1. This Trends issue summarizes a recent article in the Federal Reserve Bulletin which presents a broad overview of the major borrowing and lending trends in the U.S. economy in 1981-85. In addition, international capital flows and the role of the foreign investor is examined.
2. Demands for funds have risen at an unusually rapid rate in recent years, giving rise to a sharp expansion of debt. Total credit market debt of all sectors grew from \$4.7 trillion to \$8.2 trillion between 1980 and 1985.
3. In 1979 and 1980, the growth rate of Federal debt was a little less than 12% each year. This rate accelerated to 19 1/2% between 1981 and 1982. While the dollar value of Federal borrowing has increased in every year since, the rate of debt growth has slowed to 16%.
4. Household debt growth has exceeded that of disposable personal income in the 1980-85 period. Since 1980, the increase in income has averaged about 8% per year, while debt has grown at an average rate of 10 1/2%.
5. Much of the growth in corporate business debt, especially during the past two years, can be attributed to the massive volume of equity retirements associated with a heavy wave of mergers, acquisitions, LBOs and share repurchases. Between 1983 and 1985, about \$200 billion in stock of nonfinancial corporations was taken off the market in this fashion.
6. In 1985, the international investment position of the U.S. swung into the negative for the first time since recorded statistics were begun in 1919. Foreign assets in the U.S. outweighed U.S. assets abroad by \$107.4 billion. Interestingly, it is estimated that U.S. investors owned \$114.1 billion of foreign corporate securities as compared to foreign holdings of \$207.8 billion of such U.S. securities at year-end 1985.

Introduction

Much has been written about the mounting levels of overall debt in recent years. Yet little has been published giving a comparative perspective on this increasing demand for credit and the changing suppliers of these funds.

This Trends issue summarizes a recent article in the Federal Reserve Bulletin which presents a broad overview of the major borrowing and lending trends in the U.S. economy in 1981-85.^{1/} The article traces and measures the uses and sources of credit market funds in these years, reviews the reasons for certain shifts, and discusses structural changes which they have precipitated. In addition, an in-depth look at international capital flows and the role of the foreign investor has been added. As such, this Trends issue presents a general picture of financial developments in the U.S. economy in recent years. It should serve to answer countless questions concerning the players in today's credit markets, the pace of debt growth, and how significant the foreign investor is to the U.S. economic picture.

Uses of Funds in Credit Markets

Demands for funds by all sectors of the U.S. economy typically grow with economic activity. However, such demands have been unusually strong in recent years, giving rise to a sharp expansion of debt. Total credit market debt of all sectors expanded from \$4.7 trillion to \$8.2 trillion between year-end 1980 and year-end 1985. Meanwhile, the debt of the domestic nonfinancial sector rose from \$3.9 trillion to \$6.9 trillion during the same period. The rapid debt growth has drawn attention to the increasing role of foreign capital in satisfying the credit demands in the U.S. capital markets.

Total debt relative to GNP was fairly stable during much of the postwar period. Since 1981, however, the growth of total debt has far outpaced the rate of expansion of domestic output. The unusual acceleration of debt in the 1980s was triggered by the heavy needs of the federal government during a period of deep recession. Since 1983, however, debt of the nonfederal sectors also has accelerated. On balance, as shown in Table 1, these developments have sharply raised the amount of debt in the economy relative to output. The ratio of total domestic nonfinancial debt to GNP has risen from 138% in 1980 to 169% at the end of 1985. Indeed, with the slowing of economic growth in the past two years, the debt ratio has climbed at an unprecedented rate.

^{1/} "Major Borrowing and Lending Trends in the U.S. Economy, 1981-85," Federal Reserve Bulletin, August 1986.

Table 1
Domestic Nonfinancial Debt and Borrowing

<u>Category</u>	<u>1971-75, Average</u>	<u>1976-80, Average</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>Annual percentage change, end-of-period basis</u>							
Debt							
Federal	8.4	10.8	11.8	19.4	18.8	16.9	16.2
Nonfederal	10.1	11.7	9.0	6.8	9.7	14.0	14.6
Households	9.8	13.5	8.3	5.6	11.3	13.0	14.1
Nonfinancial business	11.0	11.8	11.1	7.6	7.7	15.4	11.3
State & local govts.	8.2	6.1	2.3	8.5	11.4	12.2	34.2
Total	9.7	11.6	9.5	9.2	11.6	14.7	15.0
Growth of nominal GNP	10.3	11.2	9.3	3.2	10.0	9.0	5.4
<u>Average annual amounts, billions of dollars</u>							
Net borrowing							
Federal	29	59	87	161	187	199	224
Nonfederal	139	274	285	234	356	567	674
Households	57	139	120	88	187	239	294
Nonfinancial business	68	120	159	120	131	283	240
State & local govts.	14	15	7	26	38	45	141
Total	168	333	373	395	543	766	898

Federal Government

Federal borrowing in the flow of funds accounts is "net borrowing from the public," which excludes changes in holdings of government trust funds.^{2/} The amount of this borrowing differs from, and is usually higher than, the federal deficit in the national income and product accounts because of differences in geographic and financial coverage.

^{2/} The flow of funds accounts, published by the Federal Reserve Board, measure the financial flows that accompany the economy's nonfinancial activities. The financial accounts present a statement of sources and uses of funds that correspond to national income concepts. Each sector of the economy receives income flows that support its current spending and saving. A sector's saving and net borrowing enable it to make investments which, through time, reflect collective preferences for tangible and financial assets in relation to liabilities.

Since 1981, several factors have contributed to unprecedented federal deficits. Large cuts in personal income taxes were enacted early in the period, and businesses were offered liberal depreciation allowances to stimulate capital formation. At the same time, there was a substantial defense buildup, and cuts in nondefense programs were not large enough to offset the rise in defense spending. Between 1981 and 1982, net federal borrowing from the public almost doubled, to \$161 billion, and the growth rate of federal debt, which had been a little less than 12% in each of the previous two years, suddenly accelerated to 19 1/2%. The dollar value of federal borrowing has continued to rise in each year through the subsequent economic recovery -- to \$224 billion in calendar 1985 -- although the percentage growth rate of federal debt has tapered off to about 16%. For the 1981-85 period as a whole, net federal demands on credit markets totaled \$858 billion.

Households

The rate of growth of household debt slowed each year from 1979 to 1982, but it has outpaced GNP growth each year since, surging more than 14% in 1985 (Table 1). In addition, household debt growth exceeded that of disposable personal income over the past five years. Since 1980, the increase in income has averaged about 8% per year, while household debt has grown at an average rate of 10 1/2%.

Since 1982, consumer credit has expanded rapidly, with annual increases of 14% to 20% in the 1983-85 interval. Net borrowing for home mortgages, which had averaged about \$100 billion per year during the late 1970s, dropped to half that amount during the 1982 downturn; it subsequently picked up sharply, increasing to \$155 billion in 1985 with the decline in interest rates and the revival of residential construction activity.

Nonfinancial Business

Debt of nonfinancial businesses has grown less rapidly in the 1980s -- about 10 1/2% per year on average -- than in the previous decade, and it has shown considerable year-to-year volatility.^{3/} Nonetheless, business borrowing, which totaled \$930 billion in the 1981-85 period, has exceeded apparent financing needs.

^{3/} Although the business sector of the flow of funds accounts includes farms and unincorporated enterprises, the dollar volume of transactions in the sector is dominated by nonfinancial corporations, and the following discussion focuses on these entities.

The borrowing needs of corporations are often measured by the so-called financing gap, that is, the difference between capital expenditures and internal funds (retained earnings and depreciation allowances) (Table 2). This indicator of external financing needs climbed to around \$60 billion during the 1979-81 period, but during the past four years it has averaged \$27 billion. On average, nominal spending on fixed investment by corporations rose 8 1/2% per year during the 1981-85 period, only half the inflation-fueled annual rate of the previous four years. Internally generated funds have been relatively ample. Pretax profits measured on an economic basis rose to record levels during the 1983-85 period, and depreciation continued to grow, also contributing to cash flow in the business sector. Notwithstanding these favorable developments, nonfinancial corporations borrowed about 3 1/2 times the total financing gap during this period (Table 2).

Much of the growth in corporate business debt -- especially during the past two years -- can be attributed to the massive volume of equity retirements associated with the heavy wave of mergers, acquisitions, leveraged buyouts, and share repurchases that occurred throughout the economy. Between 1983 and 1985 approximately \$200 billion in stock of nonfinancial corporations was taken off the market in this fashion. Although it is not always possible to link borrowing directly to equity retirements, in many cases (notably some mergers involving companies with more than \$1 billion in assets) large bank financings, commercial paper issues, and bonds were used for such purposes. Moreover, indications from

Table 2

Financing Gap and Funds Raised in Markets
by Nonfinancial Corporations
(Billions of Dollars)

Year	Capital Expenditures	Internal Funds	Financing Gap	Credit Market Borrowing	Net Equity Issuance
1981	311	250	61	104	-11
1982	267	237	30	72	11
1983	281	277	4	56	28
1984	382	322	59	192	-77
1985	369	353	17	166	-82
Total	1,610	1,439	171	590	-131

some large mergers suggest that, initially, the preponderance of equity retirements were financed by borrowing.^{4/} For the past two years at least, this activity has dominated the financing gap as the mainspring of business borrowing.

State and Local Governments

Net borrowing by state and local governments has for some years moved up strongly despite the rising surpluses shown by these governments in the national income and product accounts. Borrowing soared from about \$7 billion in 1981 to \$45 billion in 1984 and to \$141 billion in 1985. Nevertheless, during the last five years, investable surpluses of such governments averaged about \$11 billion per year. The rapid pace of borrowing by these governments often has been influenced by refunding opportunities on outstanding debt, plans for future capital expenditures, and, before recent tightenings of rules on asset acquisition, even financing arbitrage. Actual and threatened restrictions have had a pronounced effect on the amount and timing of state and local financing for several years.

Summary of Uses of Funds

As this overview suggests, special influences have caused federal borrowing and several important components of nonfederal borrowing to rise strongly in the past five years, contributing to the rapid rise in debt of both the federal and nonfederal sectors. Some of these influences appear to be waning, and there is little reason to believe that major surges and timing distortions in certain forms of debt will continue indefinitely. Legislation already in place is expected to have a restraining effect on federal borrowing and on tax-exempt debt for both public and private purposes.

Supplies of Funds to Credit Markets

All told, domestic nonfinancial sectors have borrowed almost \$3 trillion in credit markets during the past five years, and financial sectors of the economy have raised almost \$600 billion more (excluding deposits at banks and thrifts). The supply of funds has expanded correspondingly, and sources have displayed noticeable shifts in origin. This discussion will cover the provision of credit market funds to all sectors, rather than to domestic nonfinancial sectors alone, because

^{4/} Subsequent financial adjustments by companies involved in mergers and buyouts are much less visible than initial borrowing details. Some of the initial debt may have been paid down from cash flows and sales of assets; the balance possibly has been rolled over or transformed into longer maturities as interest rates have fallen, but it nonetheless remains on corporate balance sheets.

current data sources do not permit the isolation of issues of financial obligors from those of nonfinancial obligors in most debt-holders' portfolios. But since the largest portion of credit clearly flows to nonfinancial sectors, the inclusion of funds supplied to financial sectors has little effect on the picture.

Net financial investment by each sector of the economy is equal to the excess of its saving over its outlays. Total net supplies of funds to credit markets thus originate primarily in nonfinancial sectors because they generate the bulk of national saving.

For the most part, assets acquired by intermediaries are classified as "credit market instruments," such as loans, securities, and mortgages; thus the expansion of their balance sheets runs largely parallel to their supply of funds to credit markets. In contrast, a large share of assets of nonfinancial sectors are in the form of deposit claims on intermediaries. For instance, at the end of 1985 only 13% of financial assets of households were held directly in credit market forms.

The most striking feature of net credit market lending in the 1981-85 period is the almost five-fold rise of direct credit extensions by private domestic nonfinancial sectors in a period when overall borrowing roughly doubled (Table 3). Foreign lending also rose briskly while lending by financial institutions also moved higher during this period but proportionately less so than that by nonfinancial lenders.

Structural Shifts in Credit Supplies

Several developments in recent years have had noticeable effects on the structure of credit market supplies. Among these are the growing packaging of mortgage loans into marketable securities and the resurgence of mutual funds as an indirect channel to credit markets. Large quantities of formerly illiquid mortgages, typically carried to maturity by depository institutions, are being converted through mortgage pools into securities, for which markets are potentially much wider.^{5/}

Open-end investment funds (mutual funds) are another financial sector whose operations have expanded sharply toward credit market debt in recent years. In 1970, when total fund assets were \$46 billion, 85% of the total was invested in

^{5/} Mortgage pools are, broadly, a form of activity, but they are treated as a financial institution in the flow of funds accounts because of their legal form as trust accounts separate from other sectors and because of the way purchasers report their holdings of these assets.

Table 3

Net Lending in U.S. Credit Markets
(Billions of Dollars)

<u>Sector</u>	<u>1976-80, Average</u>	<u>% of Total</u>	<u>1981</u>	<u>% of Total</u>	<u>1982</u>	<u>% of Total</u>	<u>1983</u>	<u>% of Total</u>	<u>1984</u>	<u>% of Total</u>	<u>1985</u>	<u>% of Total</u>
Nonfinancial sectors	\$ 92	22.3%	\$110	22.5%	\$128	26.1%	\$186	28.6%	\$270	29.8%	\$ 415	38.0%
Private domestic	55	13.3	70	14.3	89	18.1	149	22.9	207	22.8	322	29.5
State and local governments	15	3.6	8	1.6	27	5.5	48	7.4	50	5.5	134	12.3
Households	36	8.7	48	9.8	46	9.4	74	11.4	126	13.9	185	16.9
Nonfinancial business	4	1.0	14	2.9	15	3.1	27	4.1	31	3.4	3	0.3
U.S. government	16	3.9	24	4.9	16	3.3	10	2.5	17	1.9	17	1.5
Foreign	21	5.1	16	3.3	23	4.5	27	4.1	46	5.1	76	7.0
Financial sectors	320	77.7	379	77.5	364	74.1	465	71.4	637	70.2	678	62.0
Commercial banking	100	24.2	102	20.9	107	21.8	136	20.9	182	20.1	197	18.3
Thrift institutions	66	16.0	28	5.7	30	6.1	140	21.5	146	16.1	86	7.9
Federally related mortgage pools	17	4.1	15	3.1	50	10.2	66	10.1	44	4.9	80	7.3
Mutual funds	2	0.5	5	1.0	13	2.6	15	2.3	26	2.9	90	8.2
Other	135	32.8	229	46.8	164	33.4	108	16.6	239	26.4	225	20.6
Total	\$412	100.0%	\$489	100.0%	\$491	100.0%	\$651	100.0%	\$907	100.0%	\$1,093	100.0%
Percent of total lending:												
Domestic nonfinancial sectors		17.2%		19.2%		21.4%		24.4%		24.7%		31.0%
Foreign		5.1		3.3		4.5		4.1		5.1		7.0
Financial sectors		77.7		77.5		74.1		71.4		70.2		62.0

corporate equities. Between 1981 and 1985, net investment soared \$196 billion, of which \$148 billion was directed into instruments such as taxable and tax-exempt bonds, with the remainder going to equities. At the end of 1985, about 47% of mutual fund assets were in credit market instruments, even after substantial increases in the value of their equity holdings.

Money market mutual funds are another example of indirect flows between households and credit markets. In the 1981-85 period, assets of these funds rose \$133 billion, more than 75% of which went into short-term credit market instruments. The effect is much the same as with other mutual funds, underscoring the link between financial surpluses of households and expansion of certain financial intermediaries.

Financial Accounts of Nonfinancial Corporations

As discussed earlier, stock retirements have been a major force behind the expansion of corporate borrowing well in excess of the financing gap during the past few years. One consequence of this has been a marked increase in corporate debt-equity ratios. If tangible assets are valued at current prices, the ratio rose from 35% in 1980 to more than 46% at the end of 1985, the highest figure since the early 1970s.

As interest rates declined sharply in 1985, corporations rapidly increased their activity in the bond markets. Net issuance of taxable bonds for the year totaled \$73 billion, more than during the previous two years combined; this trend has continued even faster through mid-1986. Although much of the recent surge in corporate bonds has been associated with calls and retirements of existing debt (especially by utilities), net bond issuance continued at unprecedented levels through the first half of this year, and only 40% of funds borrowed have been in short-term markets. The effect of the resurgence of long-term borrowing has been to lower the cost of existing corporate debt and to push up the long-term debt ratio a little by the end of 1985 and somewhat more this year. However, the share of liquid assets relative to short-term debt on corporate balance sheets has declined for more than two decades and was only about 40% of such debt in 1985.

Households

The household sector in the flow of funds and the national income accounts consists primarily of ordinary households but also includes personal trust and nonprofit organizations. Households are the largest sector in the economy, with about 41% of all financial assets at the end of 1985 (Table 4). Taking into account their holdings of tangible assets, households also have the largest net worth of any economic sector.

Households are the principal source of net savings in the economy; they typically invest much more in financial assets than they borrow, thereby making funds available to other sectors, which tend to be net absorbers of funds. Household financial surpluses directly and indirectly support the major part of net funds absorbed by other nonfinancial sectors such as businesses and governments. Remaining imbalances have been filled to a small extent by net surpluses of financial sectors and, to an increasing extent, by the foreign capital inflow associated with the U.S. external imbalance.

Household purchases of financial assets have exceeded personal saving by margins of \$150 to \$250 billion per year in each of the last five years, underscoring the important role played by borrowing in financing these acquisitions. Indeed, as noted earlier, household debt reached a historical high of \$2.4 trillion at the end of 1985, a 64% increase in five years. Consumer credit has expanded by 77% in the last five years (to \$666 billion at year-end 1985). Although the expansion of consumer credit often follows cyclical patterns, the past five years have witnessed the fastest growth in the past 40 years.

Table 4
Financial Assets in the U.S. Economy

<u>Sector</u>	<u>1975</u> <u>\$ Billions, year-end</u>	<u>1980</u>	<u>1985</u>	<u>1975</u>	<u>1980</u> <u>Percent</u>	<u>1985</u>
Households	2,541	4,498	7,723	42.1	41.4	41.4
Nonfinancial business	617	1,083	1,504	10.2	10.0	8.1
Private financial sectors	2,156	3,886	6,810	35.7	35.8	36.5
Commercial banking	835	1,390	2,234	13.8	12.8	12.0
Mutual funds and money market mutual funds	47	138	504	0.8	1.3	2.7
Other ^{1/}	1,274	2,359	4,072	21.1	21.7	21.8
Federally related mortgage pools	29	114	369	0.5	1.0	2.0
Foreign	235	464	813	3.9	4.3	4.4
Other ^{2/}	460	807	1,439	7.6	7.4	7.7
Total	6,038	10,852	18,658	100.0	100.0	100.0

^{1/} Savings institutions, insurance companies, private pension funds, state and local government retirement funds, finance companies, real estate investment trusts, and securities brokers and dealers.

^{2/} Federal and state and local governments, monetary authority, and sponsored credit agencies.

The ratios of debts and financial assets to disposable income have climbed noticeably in the past few years. The ratio of household debt to disposable personal income, for instance, reached a postwar high of almost 84% at the end of 1985.

Total financial assets of households rose from \$4.5 trillion at the end of 1980 to \$7.7 trillion at the end of 1985, an increase of about 72% during the interval. About 60% of these assets are concentrated in deposits (including shares in money market funds) and holdings of equities (including mutual fund shares) (Table 5). Three factors contribute to changes in the value of household financial assets: saving, borrowing, and market valuation. Total personal savings in the 1981-85 period represented less than 25% of the rise in the value of household portfolios, and net credit market borrowing by households was less than 30% of the increase. Market

Table 5
Structure of Household Balance Sheets
(Percent of total)

<u>Category</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>Billions of Dollars, 1985</u>
Financial assets				
Deposits	37.0	36.0	34.6	2,675
Equities (including mutual funds)	25.5	26.4	25.2	1,945
Credit market instruments	13.3	11.7	13.0	1,005
Pension fund reserves	16.0	19.1	22.2	1,716
Other	8.2	6.8	4.9	381
Total	100.0	100.0	100.0	7,723
Credit market debt				
Home mortgages	64.0	65.1	61.4	1,456
Consumer credit	30.4	15.9	28.1	666
Other	5.6	9.0	10.5	249
Total	100.0	100.0	100.0	2,372

valuation therefore plays a significant and sometimes dominant role in changes in the value of household financial positions. More than half of the \$1.1 trillion increase in total household financial assets in 1985 alone can be attributed to changes in market valuation; personal saving represented less than one-eighth of this gain in wealth.

The Role of Foreign Funds^{6/}

In recent years, foreign capital has played an increasing role in the supply of funds to U.S. credit markets. Any imbalance between domestic saving and investment has as its counterpart a net capital flow with the rest of the world. In effect, the "foreign sector" provides the saving (net capital inflow) needed when there is a domestic shortfall relative to investment, or absorbs such saving when there is an excess.

Net foreign investment is an overall balance, capturing measured inward and outward flows of both U.S. and foreign-owned capital, as well as components that have not been measured directly (the statistical discrepancy). The rise in the total net capital inflow corresponding to the fall in the U.S. international investment position is striking. Direct and indirect foreign support of nonfinancial borrowing reached almost 13% of credit flows in 1985, up from negative values only a few years earlier.

Focusing on components making up the international investment position of the U.S., the U.S. swung into a negative net position in 1985 for the first time since recorded statistics were begun in 1919 (See Table 6). Foreign assets in the U.S. outweighed U.S. assets abroad by \$107.4 billion. The international investment position of the U.S. had been sliding toward the negative in recent years after peaking at \$140.7 billion in 1981. In other words, foreign investment in U.S. assets has been outrunning the pace of U.S. investment in foreign assets in the 1980s. Both an acceleration of foreign capital inflows into the U.S. securities markets and the sharper price gains of U.S. assets than foreign assets contributed to the position of the U.S. as a "net importer of capital in 1985."

U.S. Assets Abroad

While direct investment abroad was the largest component of the U.S. international position in the 1970s, the 1980s witnessed a dramatic escalation of bank lending to foreigners. After increasing by about \$100 billion in 1981 and 1982, bank

^{6/} This section, unless otherwise noted, is based largely on data and information contained in "The International Investment Position of the United States in 1985," Survey of Current Business, June 1986.

Table 6

International Investment Position of the United States at Yearend, 1970-85

(Billions of Dollars)

Type of investment	1970	1975	1980 ^r	1981 ^r	1982 ^r	1983 ^r	1984 ^r	1985 ^p
NET INTERNATIONAL INVESTMENT POSITION OF THE U.S.	58.5	74.2	106.0	140.7	136.2	88.5	4.4	(107.4)
Total U.S. assets abroad	165.4	295.1	606.9	719.7	824.9	874.1	898.2	952.4
U.S. official reserves & Government assets	46.6	58.0	90.3	98.5	108.3	113.0	119.6	130.6
U.S. private assets	118.8	237.1	516.6	621.2	716.6	761.1	778.6	821.8
Direct investment abroad	75.5	124.1	215.4	228.3	207.8	207.2	213.0	232.7
Foreign securities	20.9	35.0	62.7	63.5	75.7	84.3	90.0	114.1
Bonds	14.3	25.3	43.5	45.8	56.7	57.7	62.1	73.4
Corporate stocks	6.6	9.6	19.2	17.7	19.0	26.6	27.9	40.7
U.S. nonbanking claims on unaffiliated foreigners	8.5	18.3	34.7	35.9	28.6	35.1	30.0	28.2
U.S. bank claims, not included elsewhere	13.8	59.8	203.9	293.5	404.6	434.5	445.6	446.7
Total foreign assets in the U.S.	106.9	220.9	500.8	578.0	688.7	785.6	893.8	1059.8
Foreign official assets	26.2	86.9	176.1	180.4	189.1	194.6	199.1	202.3
Other foreign assets in the U.S.	80.8	134.0	324.8	398.6	499.6	591.0	694.7	857.5
Direct investment	13.3	27.7	83.0	108.7	124.7	137.1	164.6	183.0
Treasury securities	1.2	4.2	16.1	18.5	25.8	33.9	58.3	83.8
Securities other than Treasury securities	34.8	45.7	74.1	75.4	93.6	114.7	128.6	207.8
Corporate & other bonds	7.6	10.0	9.5	10.7	16.8	17.5	32.7	81.8
Corporate stocks	27.2	35.6	64.6	64.6	76.8	97.3	95.8	126.0
U.S. nonbanking liabilities to unaffiliated foreigners	8.8	13.9	30.4	30.6	27.5	26.9	31.0	29.1
U.S. bank liabilities, not included elsewhere	22.7	42.5	121.1	165.4	228.0	278.3	312.2	353.8

r=Revised
p=Preliminary

Source: Survey of Current Business, June 1986.

lending abroad slowed significantly in 1983 and was virtually stagnant in 1984-85. The international debt repayment crisis as well as domestic problems led U.S. banks to sharply cut back on international lending. In addition, international demand for U.S. bank credit remained constrained by moderate economic growth and the availability of attractively priced financing alternatives in the securities markets. This curtailment of bank loan activity represents the most significant factor in the swing of the U.S. position.

U.S. portfolio holdings of foreign securities are estimated at \$114.1 billion at year-end 1985, having increased some 27% from 1984 based on net purchases of \$8.0 billion, price gains of \$12.0 billion and currency appreciation. Of this amount, \$40.7 billion represents stock holdings which enjoyed a 30% to 50% price appreciation boost given the strong performance of the major foreign markets. U.S. holdings of foreign bonds increased to \$73.4 billion in 1985. Similar to stocks, price appreciation overshadowed net purchases. All told, U.S. foreign securities investment increased 82% from \$62.7 billion in 1980 to year-end 1985. In contrast, foreign investment in U.S. securities other than Treasuries increased by 180% over the same period.

Foreign Assets in the U.S.

Foreign acquisition of U.S. securities reached an unprecedented level in 1985. Other than those securities included in foreign official assets, foreign investors held about \$291.6 billion of U.S. Treasuries, stocks and corporate bonds at year-end 1985. Of this total, \$83.8 billion, or 29%, represents U.S. Treasury issues. Net purchases of Treasuries in 1985 by private foreigners and international organizations reached a dramatic \$20.7 billion, with two-thirds of this amount bought by Japanese investors. The liberalization of Japanese restrictions of foreign holdings by institutions coupled with a sizable interest rate differential favoring U.S. issues prompted the dramatic increase in Japanese activity.

Much attention has focused on foreign accumulation of Treasuries. However, put into perspective as a proportion of Treasury debt, foreign holdings have actually declined, given the rapid growth of the debt itself. At midyear 1985, foreign holdings of Treasury debt stood at 11.3%, the lowest since 1971 and down from a peak of 17.5% in 1978.^{7/} Also contributing to the lowered proportion was the slowdown in acquisition by foreign official institutions as central banks adopted a policy of limited intervention in foreign exchange markets. Nevertheless, while foreign official holdings were declining,

^{7/} "The Internationalization of Uncle Sam," Economic Perspectives, Federal Reserve Bank of Chicago, May/June 1986.

foreign private demand increased from 14% of total foreign Treasury holdings in 1981 to 35% as of September 1985.^{8/}

The foreign appetite for U.S. securities other than Treasuries also escalated sharply in 1985. Total stock and bond holdings jumped by 62% to \$207.8 billion from \$128.6 billion in 1984. While stock holdings increased 31% to \$126.0 billion in 1985, foreign holdings of corporate and other bonds leaped by 1 1/2 times to \$81.8 billion from \$32.7 billion in 1984. Record net purchases of \$50.9 billion clearly exceeded price gains of \$26.8 billion.

The substantial rise in foreign bond holdings reflects a number of factors. With the removal of the U.S. foreign withholding tax on interest in 1984, many companies started to raise funds directly in foreign markets. Thus, previous intercompany flows began to be captured in the securities component of the international position. In addition, comparably high U.S. interest rates coupled with the elimination of the withholding tax helped spur foreign demand for U.S. bonds.

Summary

A review of these developments shows that special factors may have contributed to exceptionally heavy borrowing during the 1981-85 period. Although the underlying pace of borrowing appears to be slowing, growth of debt still exceeds that of GNP by a considerable margin. The heavy credit demands have been met through shifts in the structure of the supply of funds, by the more active role played by financial transformations such as mortgage pools and mutual funds, and, notably, by the net inflows of foreign saving. Any adjustment of the external accounts toward equilibrium and the corresponding fall in the supply of foreign saving will be a significant factor in domestic credit markets in the period ahead.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

^{8/} Ibid

VOLUME

	JULY 1986	JAN - JULY 1986	JULY 1985	JAN - JULY 1985	% CHAN. J-JL 1986-1985
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	137.7	140.4	112.0	108.4	29.6%
AMEX (MILS.)*	10.3	12.8	7.3	8.2	56.4%
NASDAQ (MILS.)*	110.7	119.9	72.4	78.6	52.6%
REGIONAL EXCHANGE (MILS.)*	22.6	23.4	18.1	18.7	25.0%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	\$118,057	\$794,553	\$88,134	\$561,107	41.6%
AMEX (MILS.)	3,671	26,342	2,168	14,964	76.0%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	9,143	65,074	7,393	48,942	33.0%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	17,422	129,095	15,600	109,993	17.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.6%	49.4%	53.3%	51.8%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	16,050	109,671	11,617	82,302	33.3%
AMEX OPTIONS	5,806	29,958	3,128	19,714	52.0%
COMMODITY	15,080	110,859	13,866	92,266	20.2%

*MONTHLY AVERAGE

YIELDS

(MONTHLY AVERAGES)

BOND BUYER INDEX (20 BOND)

CORPORATE BOND YIELDS (MOODY'S)

Aaa CORPORATE

Baa CORPORATE

RATIO Aaa CORPS. TO Baa CORPS.

MUNICIPAL BOND YIELDS (MOODY'S)

AUGUST 1986	AUGUST 1985	BASIS POINT CHG: 1986-1985
7.21%	9.08%	(187)
8.72	11.05	(233)
10.18	12.50	(232)
0.86	0.88	(2)
7.21	9.08	(187)

PRICES (END OF MONTH)

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

AUGUST 1986	AUGUST 1985	% CHAN. Y-T-D 1986-1985
1898.34	1334.01	42.30%
252.93	188.63	34.09%
145.32	109.39	32.85%
273.85	235.25	16.41%
236.37	199.91	18.24%
382.86	297.71	28.60%

UNDERWRITING

	JULY 1986	JULY 1985	% Change 1986-1985
CORPORATE FINANCING (Gross New Issues - \$ Mils)			
TOTAL	\$20,134.2	\$13,138.9	53.2%
Common Stock	\$2,804.1	\$2,633.0	6.5%
# of Common Stock Issues	121	63	92.1%
Preferred Stock	\$1,163.4	\$1,108.5	5.0%
# of Preferred Stock Issues	19	13	46.2%
Corporate Debt	\$16,166.7	\$9,397.4	72.0%
# of Corporate Debt Issues	188	110	70.9%
MUNICIPAL FINANCING (Gross New Issues - \$ Mils)			
Notes	\$4,890.9	\$5,128.7	-4.6%
Bonds	\$20,394.6	\$13,086.3	55.8%

Source: IDD Information Services and Bond Buyer

MARGIN DEBT

MARGIN DEBT OUTSTANDING (\$MILS)
 NET CHANGE IN MARGIN DEBT (\$MILS)
 % OF ACCOUNTS WITH EQUITY UNDER 40%

AUGUST 1986	AUGUST 1985	% CHANGE 1986-1985
33,170	25,780	28.7%
7,950	2,970	167.7%
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RECENT INTERESTING READING AND STATISTICAL MATERIAL

<u>Item</u>	<u>Description</u>	<u>Source</u>
<u>Securities Industry Data Guide</u>	SIA booklet detailing wheres, whats, and hows of accessing existing industry data. Covers industry areas such as underwritings, firm rankings, market data, mutual funds, employee and firm earnings, exchange figures, and more, giving the provider's address and phone as well as price. First comprehensive guide published to obtaining securities industry facts and data.	SIA Publications Dept. \$5.00
<u>Report on Branch Manager Earnings in 1985</u>	SIA's 65-page study based on input from 27 SIA member firms reporting on over 1,700 branch managers. In addition to information on the methods of compensating branch managers, this report presents data on profit margins, bonus practices, and earning levels broken down by state and by major metropolitan area.	SIA Surveys Department Participating Firms: \$50 Member Firms: \$400 Non-Members: \$1,200
"Tax Reform Pre-Game Show"	Brief examination of some of the fundamental questions that govern how corporations finance themselves and how tax reform will change the answers to those questions. Comments on capital raising, M&A, corporate structure, cash management, and the alternative minimum tax.	<u>Investment Dealers'</u> <u>Digest</u> 9/1/86
<u>U.S. Treasury Securities - The Market's Structure, Risks, and Regulation</u>	First of several reports examining the operation of the government securities market. 3-main sections of the report provide general description of the government securities market, its risks, and its present regulatory structure. The appendixes give more detail on specific matters such as growth and the composition of debt, control of risk by dealers, the mechanics and use of repurchase agreements, the workings of the future and options markets and other selected topics.	U.S. General Accounting Office P.O. Box 6015 Gaithersburg, MD 20877

"Big Bang Brief"

The "Big Bank" in London on October 27th will "blow up" restrictive practices in Britain's financial markets: fixed commission rates, demarcation lines between brokers and jobbers, and jobs in the gilts markets. The Economist is running a series of articles covering different aspects of the "Big Bang", which has included regulatory concerns, a survey of financial institutions gearing-up plans, and a review of lessons to be learned from Mayday.

The Economist
Start of series:
8/2-8 issue

"Hidden Risks in Portfolio Insurance"

Under portfolio insurance (PI), a pension fund manager makes a contract with a PI firm to maintain a floor, or set market value, for the fund. Stock index futures contracts are the hedging device used. Article explains how PI works and its pros and cons.

Dun's Business Month
September 1986

"Change & the Securities Industry: More "Future Shock" in the Future?"

Highlights of the major changes in the securities industry since the early 60s and projections on the future by Peter Loeb. Concludes that the retail side of the business is doing better each year, but the capital markets area may be placing too much emphasis on short-term rather than long-term perspectives.

The Columbia Journal
of World Business
20th Anniversary
Commemorative Issue
Columbia University, N.Y.

Choosing Among Consumption Taxes

Although the Tax Reform Act of 1986 has yet to be signed into law, observers are focusing on the possibility of tax increases to reduce the federal deficit. One tax alternative that has been growing in popularity is the consumption tax. This study covers the principal features of various consumption taxes, their relative pros and cons, administrative considerations, and some key questions associated with a consumption tax.

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